Fin Mkts Portfolio Mgmt (2007) 21: 491–492
DOI 10.1007/s11408-007-0065-3

BOOK REVIEW

Pompian, M. (2006): Behavioral Finance and Wealth Management – How to Build Optimal Portfolios That Account for Investor Biases

John Wiley & Sons, Inc, 101 CHF, 318 pages

Alexander Ising

Published online: 16 October 2007

In "Behavioral Finance and Wealth Management—How to Build Optimal Portfolios That Account for Investor Biases," Michael Pompian summarizes results from the area of behavioral finance and shows how to construct optimal portfolios in the presence of biases. I recommend the book to anyone working in the field of portfolio management because it delivers a good overview of investors' behavioral biases.

The book is divided into 27 chapters which are organized in four parts. The first part is an introduction to the field of behavioral finance. Part 2 overviews the relevant literature of different behavioral biases and presents hands-on advice for practice. Case studies are presented in the third part. In the last part, original research of the author is presented.

The first chapter includes the challenges to the two standard finance assumptions, rational markets and the homo oeconomicus. The most prominent researchers/figures in the area as well as their main contributions are introduced. Subsequently, the history of the field is presented, from its emergence to the most recent developments. The focus is on findings in microeconomics, since the aim of the book is to show the implications for private investors. Practical applications start in the third and final chapter of this part. This chapter introduces the framework for portfolio management. Instead of presenting an analytical framework, the author gives particular advice on how to diagnose behavioral biases within investors.

The second part of the book presents the contribution of the book. Each of the 20 chapters presents one particular bias and its behavioral explanation. Additionally a concrete practical application shows the use of the bias in practical situations and outlines implications for investors for each bias. A thorough discussion of the relevant literature is held in each chapter. Also, practical advice is given, such as how

A. Ising (✉)
Swiss Institute of Banking and Finance, University of St. Gallen, St. Gallen, Switzerland
e-mail: alexander.ising@unisg.ch

to test whether an investor or advisor is prone to the particular effect and how to manage it. Chapter 4 of the book deals with overconfidence, i.e., people tend to overestimate their abilities and the importance of their information. Then chapters 5 to 23 contain the following biases in chronological order: representativeness, anchoring and adjustment, cognitive dissonance, availability, self-attribution, illusion of control, conservatism, ambiguity aversion, endowment, self-control, optimism, mental accounting, confirmation, hindsight, loss averion, recency, regret aversion, framing, and status quo.

Part 3 of the book implies case studies. Chapter 24 shows in three examples how the biases presented in the previous part show up in portfolio management. Effects and problems are addressed and solutions presented. In particular, advice on how to incorporate the effects into allocation decisions is valuable.

The last part of the book presents more recent research and results. Chapter 25 investigates whether investors are more prone to the different effects if they are of a certain personality type or gender. A classification of investors in types according to personality is presented in the next chapter. Also, a test for the type of investor is presented. These results are original research by the author. Finally, the last chapter of the book concludes with an outlook into neuroeconomics. This new field of study is frequently seen as the next step in behavioral finance research.

The book is written for practitioners, in particular, client managers in wealth management. It is a helpful and valuable overview of behavioral finance. In a nonquantitative way, it presents the "behavioral biases" and shows their implication for portfolio construction.

I recommend the book to anybody who wants to get an introduction to behavioral finance. Since the book does this in a nonquantitative way, I do not think it is suitable for someone who expects portfolio strategy with incorporating behavioral biases.